



SENATE PCS 94: IRC Update

2011-2012 General Assembly

Committee:	Senate Finance	Date:	February 23, 2011
Introduced by:	Sens. Hartsell, Tillman, Newton	Prepared by:	Cindy Avrette
Analysis of:	PCS to First Edition S94-CSRBx-6		Committee Counsel

SUMMARY: *Senate Bill 94¹ would update the reference to the Internal Revenue code used in defining and determining certain State tax provisions from May 1, 2010, to January 1, 2011. By doing so, North Carolina would conform to many of the changes made by the federal Small Business Jobs Act of 2010 and the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, including part of the estate tax changes, a modified version of the enhanced section 179 expense deduction changes, and all of the business and individual income tax extenders from the Bush-era tax legislation of 2001. Senate Bill 94 would not conform to the bonus depreciation provisions. This bill is a recommendation of the Revenue Laws Study Committee. With the exception of the estate tax, the bill's impact on General Fund availability is minimal.*

The proposed committee substitute clarifies the State's conformity on three issues identified by practitioners and the Department of Revenue: the definition of qualifying property for purposes of the section 179 expense deduction and the basis of property passing through an estate.

The proposed committee substitute differs from the one you received last night. It modifies the provisions based upon further comments received from the practitioners and the Department of Revenue.

CURRENT LAW: North Carolina's tax law tracks many provisions of the federal Internal Revenue Code by reference to the Code.² The General Assembly determines each year whether to update its reference to the Code.³ Updating the reference makes recent amendments to the Code applicable to the State to the extent that State law previously tracked federal law. The General Assembly's decision whether to conform to federal changes is based on the fiscal, practical, and policy implications of the federal changes and is normally enacted in the following year, rather than in the same year the federal changes are made. Maintaining conformity with federal tax law simplifies tax reporting because a taxpayer will not need to account for differing federal and State treatment of the same asset.

¹ SB 94, as introduced, was identical to HB 124, introduced by Representatives Howard, Brubaker, Starnes, and Setzer. HB 124 is in House Finance.

² North Carolina first began referencing the Internal Revenue Code in 1967, the year it changed its taxation of corporate income to a percentage of federal taxable income.

³ The North Carolina Constitution imposes an obstacle to a statute that automatically adopts any changes in federal tax law. Article V, Section 2(1) of the Constitution provides in pertinent part that the "power of taxation ... shall never be surrendered, suspended, or contracted away." Relying on this provision, the North Carolina court decisions on delegation of legislative power to administrative agencies, and an analysis of the few federal cases on this issue, the Attorney General's Office concluded in a memorandum issued in 1977 to the Director of the Tax Research Division of the Department of Revenue that a "statute which adopts by reference future amendments to the Internal Revenue Code would ... be invalidated as an unconstitutional delegation of legislative power."

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BILL ANALYSIS: The current reference to the Code is May 1, 2010.⁴ Since that time, Congress has enacted two Acts that make substantial changes to the tax code: the Small Business Jobs Act of 2010, enacted September 27, 2010, as P. L. 111-240 (2010 Jobs Act), and the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act, enacted December 17, 2010, as P. L. 111-312 (2010 Tax Relief Act). Both Acts contain provisions that became effective retroactively on January 1, 2010. Since the General Assembly will not have had an opportunity to enact legislation prior to the end of the 2010 taxable year, taxpayers may have to make adjustments on their 2010 State tax return for items included in, or excluded from, federal taxable income as a result of one of these two Acts.

The 2010 Jobs Act enhances existing business tax incentives and partially offsets this revenue loss with changes which are expected to increase revenue. The incentives in the 2010 Jobs Act are not limited to small businesses, and the accelerated deduction for depreciation represents a major benefit to large businesses. The 2010 Tax Relief Act boosts some of the business tax incentives in the 2010 Jobs Act and extends the Bush-era individual and business tax incentives, included in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA)⁵, for two years.

Extension of 50% Bonus Depreciation for 2010, 2011, and 2012

Businesses may depreciate the cost of a new asset⁶ over a period of time, usually five to 15 years. Bonus depreciation allows a business to claim more of a deduction up front and spread the remainder out over the normal depreciation schedule. The federal Economic Stimulus Act of 2008⁷ provided a 50% first year bonus depreciation for qualified property acquired and placed in service in 2008. The federal American Recovery and Reinvestment Act of 2009 extended the 50% bonus depreciation provided to qualified property for an additional year through 2009.

The 2010 Jobs Act extends the bonus depreciation for 2010 and applies retroactively to property acquired and placed in service in 2010.⁸ The 2010 Tax Relief Act increases the 50% bonus depreciation extended under the 2010 Jobs Act to 100% for property acquired and placed in service after September 8, 2010, and before January 1, 2012. It also provides 50% bonus depreciation for qualified property placed in service after December 31, 2012, and before January 1, 2013. Under the 2010 Jobs Act, the bonus depreciation would have expired for the 2012 taxable year. Under the 2010 Tax Relief Act, the bonus depreciation expires for the 2013 taxable year.

The 2010 Jobs Act also allows taxpayers using the percentage of completion accounting method to benefit from bonus depreciation at the federal level for assets with a depreciable life of seven years or less. The percentage of completion accounting method might prevent taxpayers from receiving benefit from the bonus depreciation because the accounting method spreads expenses, including depreciation,

⁴ Part 31 of S.L. 2010 31 updated the reference to the Internal Revenue Code used in defining and determining certain State tax provisions from May 1, 2009, to May 1, 2010. However, S.L. 2010 31 did not conform to the five year carryback of net operating losses incurred by large businesses. S.L. 2010 31 incorporated tax changes made by five federal acts: the Worker, Homeownership, and Business Assistance Act (WHBA), P.L. 111-92; Acceleration of Income Tax Benefits for Haiti Relief, P.L. 111-126; the Patient Protection and Affordable Care Act, P.L. 111-148; the Health Care and Education Reconciliation Act, P.L. 111-152; and the Hiring Incentives to Restore Employment Act (HIRE), P.L. 111-147.

⁵ Most of the tax provisions in EGTRRA were scheduled to expire in 2010 or 2011 and revert to the provisions as they existed in 2001.

⁶ One important difference between bonus depreciation and section 179 expensing is that bonus depreciation applies only to new equipment, while section 179 expensing may apply to new and used equipment.

⁷ Congress has authorized bonus depreciation several times to encourage business investment, specifically after September 11, 2001. The Jobs Creation and Worker Assistance Act of 2002 provided a 30% bonus depreciation allowance. The Jobs and Growth Tax Relief Reconciliation Act of 2003 extended the sunset and increased the amount to 50%.

⁸ The property may be placed in service during 2011 for property with a recovery period of 10 years or longer and for transportation property (*i.e.*, tangible personal property used to transport people or property).

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throughout the life of a long-term contract. Under this accounting method, taxpayers could not deduct the bonus depreciation in the first year. Construction contractors use the percentage of completion accounting method. This provision is new.

North Carolina decoupled from the extension of the bonus depreciation provisions in 2008 and 2009. The State delayed the impact of the bonus depreciation deduction in a manner similar to what it has done in the past: State tax law provides that a taxpayer may deduct the same amount of an asset's basis under State law as under federal law, it is just that the timing of the deduction differs. Under State tax law, a taxpayer must add back 85% of the accelerated depreciation amount⁹ in the year that it is claimed for federal purposes. Then, in subsequent tax years, the taxpayer may deduct from federal taxable income the total amount of the add-back, divided into five equal installments. This adjustment means that for State tax purposes, a taxpayer may deduct a greater depreciation amount in the outlying tax years, which will be the normal depreciation amount plus 20% of the accelerated depreciation amount the taxpayer had to add back.

Senate Bill 94 would decouple from the bonus depreciation provisions for 2010, 2011, and 2012 in the same manner as it has decoupled from them in the past: A taxpayer would add-back 85% of the accelerated depreciation amount in the year that it is claimed for federal purposes. Then, in subsequent tax years, the taxpayer would deduct from federal taxable income the total amount of the add-back, divided into five equal installments.

Enhanced Section 179 Expensing for 2010, 2011, and 2012

Section 179 of the Code allows the expensing of the purchase price of some business assets¹⁰ in the year of purchase rather than taking depreciation¹¹ throughout the life of the asset. In other words, expensing trades a smaller yearly deduction over time for a larger deduction in year one.

Prior to the Emergency Economic Stabilization Act of 2008 (EESA), the deduction limit for section 179 expensing was \$128,000¹² of the cost of the property with a dollar for dollar phase-out of this amount whenever the total cost of qualifying property placed in service that year exceeded \$510,000.¹³ EESA increased the deduction limit from \$128,000 to \$250,000 with a phaseout at \$800,000 for the 2008 tax year. The American Recovery and Reinvestment Tax Act of 2009 (ARRTA) extended the temporary increase through 2009. The federal HIRE Act of 2010 extended the 2008 and 2009 increase through 2010. The limits were scheduled to revert to the prior levels of \$25,000 and \$200,000 in taxable year 2011. North Carolina conformed to those changes.

The 2010 Jobs Act not only delayed the reversion to the prior levels until the 2012 taxable year, it also increased the section 179 expensing deduction for tax years 2010 and 2011 from \$250,000 and \$500,000 to \$800,000/\$2 million. In addition to the expansion of the limits, the Act broadened the definition of qualified property to include qualified leasehold improvement property, qualified restaurant property, qualified retail improvement property, and computer software.¹⁴ The enhancements made by the 2010

⁹ The accelerated depreciation amount for property placed in service in 2008 is 50%.

¹⁰ The business asset must be newly purchased tangible personal property that is used more than 50% for business purposes and is eligible to be depreciated under the Code. The newly purchased property may be new or used equipment.

¹¹ Generally, taxpayers take the Section 179 expensing deduction first and claim Section 168(k) depreciation on any remaining basis.

¹² Prior to the EESA, the dollar limits would have been \$125,000 with a phase-out beginning at \$500,000; both amounts would have been indexed for inflation resulting in the limits of \$128,000 and \$510,000.

¹³ For example, if the taxpayer placed in service during the taxable year one or more items of qualifying property totaling \$520,000, the amount that could be expensed under section 179 would be \$118,000 -- \$128,000 less \$10,000, which is the excess of \$520,000 over \$510,000.

¹⁴ Qualified real property is limited to a maximum deduction of \$250,000.

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Jobs Act are set to expire for the 2012 taxable year. The 2010 Tax Relief Act does not continue the expansion of the types of property that may qualify for the deduction beyond the 2011 taxable year, but it does increase the limits for the 2012 taxable year from \$25,000 and \$200,000 to \$125,000 and \$500,000. Under the 2010 Tax Relief Act, the deduction limits are set to revert to their prior levels of \$25,000 and \$200,000 in 2013.

North Carolina has conformed to the enhanced section 179 expense deduction provisions in the past. However, the enhancements made by the 2010 Jobs Act are the most expansive ever enacted. Senate Bill 94 would conform to the expanded definition of qualified property; it would maintain the 2010 deduction limits of \$250,000 and \$800,000 for taxable years 2010 and 2011; and it would decouple from the enhanced limits of \$500,000 and \$2,000,000 for taxable years 2010 and 2011. Senate Bill 94 would provide that the property's basis would be the same for federal and State purposes and would treat the difference in the same manner as State tax law has historically treated the bonus depreciation: A taxpayer would add-back 85% of the additional expensing taken under federal law in 2010 and 2011 and would deduct 20% of this amount over the succeeding five years. Senate Bill 94 would conform to the expensing limits of \$125,000 and \$500,000 for the taxable year 2012 and, like federal law, would revert to the prior expense limits of \$25,000 and \$200,000 for the tax year 2013.

Estate Tax for 2010 - 2012

EGTRRA gradually reduced the federal estate tax over a period of years and abolished it for decedents dying in 2010. During the year of its repeal, the basis of property passing through an estate was determined by the modified carryover basis rules under EGTRRA. EGTRRA also repealed the state estate tax credit for decedents dying on or after 2004 and replaced the credit with a deduction. The estate tax was scheduled to revert to the 2001 law in 2011: the 2001 maximum estate tax rate of 55% and a \$1 million applicable exclusion amount.

The 2010 Tax Relief Act revives the estate tax retroactively for decedents dying on or after January 1, 2010, and thereby allows property passing through the estate to acquire a stepped-up basis. The maximum federal estate tax rate is 35% with an applicable exclusion amount of \$5 million. The 2010 Tax Relief Act also provides for portability between spouses of the exclusion amount. This portability means that any unused exclusion amount by one spouse is available to the surviving spouse, effectively allowing a married couple to exclude up to \$10 million from estate tax.¹⁵ The new estate tax law is scheduled to sunset on December 31, 2012, to the pre-EGTRRA amounts. The 2010 Tax Relief Act gives the estates of decedents dying in 2010 the option to pay no estate tax and assume the modified carryover basis in the property.

North Carolina imposes an estate tax on the estate of a decedent when a federal estate tax is imposed on the estate.¹⁶ By virtue of this language, the federal and state exclusion amounts are the same. The amount of the State's estate tax is the amount of the credit allowed on the federal estate tax return for state estate tax paid, as the federal law provided in 2001.¹⁷

¹⁵ The portability election is set to sunset December 31, 2012. Therefore the utility of the portability election is limited to situations where both spouses die within the two-year term (2011 and 2012).

¹⁶ North Carolina repealed its inheritance tax in 1998 and replaced it with an estate tax that was equivalent to the federal state estate tax credit allowed on a federal estate tax return. This type of state estate tax was known as a "pick up" tax because it picked up for the state the amount of federal estate tax that would otherwise be paid to the federal government.

¹⁷ When Congress phased out the state estate tax credit, beginning in 2002, North Carolina enacted legislation not to conform to the phase out of the credit. In other words, North Carolina began tying the amount of the State estate tax owed to the federal credit as it existed in 2001 rather than as it currently exists. Georgia, South Carolina, and Tennessee have not had an estate tax since January 1, 2005, because their estate tax equals the amount of the state estate tax credit allowed on the federal estate tax return. Virginia repealed its estate tax, effective July 1, 2007.

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Since the federal estate tax did not exist in 2010, North Carolina's estate tax was repealed for 2010. With the revival of the federal estate tax in 2011, North Carolina's estate tax is revived for decedents dying in 2011.¹⁸ Senate Bill 94, by conforming to the definition of federal taxable income for income tax purposes, also adopts the federal basis of any property passing through an estate. Unlike Congress, North Carolina cannot the estate tax retroactively¹⁹ on the estates of decedents dying on or after January 1, 2010, and before January 1, 2011. The effective date clarifies this constitutional restriction.

Business Tax Extenders for 2010 and 2011

The 2010 Tax Relief Act extended many of the tax incentives enacted in EGTRRA for two years. The business tax incentives included enhanced deduction and expensing items, charitable deductions, and tax credits. North Carolina conformed to these incentives in 2002²⁰; however, under existing North Carolina law, these incentives expired for the 2010 taxable year. Senate Bill 94 would conform to these extensions.

The 2010 Tax Relief Act extended the following business tax incentives that were set to expire for the 2010 taxable year for the 2010 and 2011 taxable years:

- 15-year recovery period for qualified leasehold improvements, restaurant building and improvements, and retail improvements
- Seven-year recovery period for motor sports entertainment costs recovery
- Expensing election for certain film and television production costs
- Brownfields remediation expensing

The 2010 Tax Relief Act extends the Work Opportunity Tax Credit (WOTC) to include individuals who begin employment after August 31, 2011, and before January 1, 2012. The WOTC is equal to 40% of up to \$6,000 of the targeted employee's qualified first year wages. North Carolina's WOTC is equal to 6% of the federal WOTC for wages paid for positions located in this State. The federal WOTC was scheduled to expire September 1, 2011.

The 2010 Tax Relief Act extends the following charitable incentives for taxable years 2010 and 2011:

- Deduction for contributions of food inventory
- Deduction for contributions by C corporations of books to public schools
- Deduction for corporate contributions of computer equipment for educational purposes
- Basis adjustment to stock of S corporations making charitable contributions of property

Individual Income Tax Extenders for 2010, 2011, and 2012

The 2010 Tax Relief Act extends many of the Bush-era individual tax incentives included in the EGTRRA for two years. Some of the tax incentives expired in 2010 and others were scheduled to expire in 2011. North Carolina conformed to these incentives in 2002²¹; however, under existing North Carolina law, many of these incentives expired for the 2010 taxable year and others are scheduled to expire for the 2011 taxable year. Senate Bill 94 would conform to these extensions.

¹⁸ North Carolina's estate tax would have been revised in 2011 based upon the Code as written on May 1, 2010.

¹⁹ Article I, Sec. 16 of the North Carolina Constitution.

²⁰ S.L. 2002-126.

²¹ S.L. 2002-126.

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The following three individual income tax incentives were scheduled to expire in 2010, but the 2010 Tax Relief Act extends the incentives retroactively for the 2010 tax year and the 2011 tax year:

- Tax deduction for higher education tuition expenses
- Up to \$250 deduction for teacher's classroom expenses
- Charitable contribution of IRA proceeds

The following individual income tax incentives were scheduled to expire in 2011, but 2010 Tax Relief Act extends the incentives for the 2011 and 2012 taxable years:

- *No limitation on itemized deductions.* Section 68 of the Code, first added in 1990, established an overall limitation on itemized deductions. This limitation was gradually repealed starting in 2006, with the phase-out complete in taxable year 2010. The limitation was scheduled to revert in full in 2011. The 2010 Tax Relief Act extends the complete repeal of the limitation for 2011 and 2012.
- *Enhancements to the earned income tax credit (EITC).* The EITC is a refundable tax credit that varies depending on the number of the taxpayer's qualifying children. North Carolina's EITC is equal to 5% of the federal credit amount. EGTRRA increased the EITC from 40% to 45% of a family's first \$12,570 of earned income for families with three or more children and an increase in the beginning point of the phase-out range for married coupled filing a joint return by \$1,880. The enhancements were set to expire for the 2011 taxable year. The 2010 Tax Relief Act extends the enhancements through the 2011 and 2012 taxable years.
- *Enhancements to the adoption tax credit.* EGTRRA increased the dollar limitation for the credit and the income exclusion for employer paid expenses to \$10,000, indexed for inflation. The Patient Protection and Affordable Care Act increased the credit and exclusion by another \$1,000 for 2010 and 2011. The credit cap was scheduled to return to \$5,000²² for taxable years beginning on or after January 1, 2012. North Carolina's adoption tax credit is equal to 50% of the federal credit amount. The 2010 Tax Relief Act extends the enhancements made by EGTRRA for one year. Under the Act, the credit caps will revert to their prior levels in taxable year 2013.
- *Deductibility of mortgage insurance premiums.* Mortgage insurance premiums became deductible in 2007. The insurance must be in connection with home acquisition debt for a first or second home. The deduction is subject to phase-out based on a taxpayer's income. The deductibility of mortgage insurance premiums was set to expire for taxable year 2011. The 2010 Tax Relief Act extends the deduction for one more year, through taxable year 2011.
- *Educational assistance exclusion.* EGTRRA allowed employees to exclude up to \$5,250 in employer-provided education assistance from income and employment taxes. The exclusion was set to expire for taxable year 2011. The 2010 Tax Relief Act extends the exclusion for taxable years 2011 and 2012.
- *Student loan interest deduction.* The student loan interest deduction is a deduction from gross income used to determine a taxpayer's adjusted gross income (AGI). The deduction is subject to a phase-out based on the taxpayer's AGI. EGTRRA eliminated the rule that the deduction only applies to payments made during the first 60 months that interest payments were

²²The limit is \$6,000 for a special needs child.

required and it increased significantly the phase-out amounts. These changes were set to expire in 2011, but the 2010 Tax Relief Act extends the changes for taxable years 2011 and 2012.

- *Coverdale education savings accounts.* Coverdale education savings accounts allow a taxpayer to make nondeductible contributions and to withdraw the proceeds tax free if they are used towards educational expenses. EGTRRA increased the amount that may be contributed to an account from \$500 to \$2,000 and it made elementary and secondary school expenses qualified expenses. The enhancements were set to expire for the 2011 taxable year. The 2010 Tax Relief Act extends the enhancements for taxable years 2011 and 2012.
- *Qualified scholarships.* Qualified scholarships may be excluded from taxable income. EGTRRA provided that the national Health Services Corps Scholarship Program and the Armed Forces Scholarship Program are qualified scholarships for exclusion for income purposes. These scholarships were scheduled to be included in a recipient's income in taxable year 2011. The 2010 Tax Relief Act extends the income exclusion for taxable years 2011 and 2012.

Miscellaneous Business Incentives

The 2010 Jobs Act provided several tax incentives for businesses. Senate Bill 94 would conform to these incentives.

- *Increase in amount allowed as a deduction for start-up expenditures.* The Code allows up to \$5,000 of start-up expenses to be deducted. The deduction is reduced by the amount of start-up costs that exceed \$50,000. The 2010 Jobs Act increased the deduction to \$10,000 for start-up and organization expenses of the taxpayer's trade or business in 2011 and increased the phase-out threshold to \$60,000.
- *Modification to exclusion for gain from certain small business stock.* Fifty percent of the gain realized on qualified small business stock may be excluded from income. To qualify, the stock must be purchased at its original issue and the aggregate gross assets of the issuing corporation may not exceed \$50 million and at least 80% of the value of its assets must be used in the active conduct of one or more trades or businesses. The exclusion is capped at the greater of 10 times the taxpayer's basis in the stock or \$10 million. ARRTA temporarily increased from 50% to 75% the exclusion for qualified small business stock sold by an individual. The increased exclusion percentage is applicable to stock acquired after February 17, 2009, and before January 1, 2011. North Carolina conformed to ARRTA's temporary increase of the exclusion. The 2010 Jobs Act increased the exclusion percentage to 100% for stock acquired after September 27, 2010, and before January 1, 2011.

Provisions in the 2010 Jobs Act Designed to Increase Revenue

The 2010 Jobs Act contained provisions to increase revenues. The provisions projected to raise the most revenue were related to higher federal tax penalty provisions. These provisions would not apply to North Carolina and would not increase any revenues payable to North Carolina. The Act also contained some retirement-friendly provisions that, if chosen by the taxpayer, would encourage up-front distributions that would be taxable. Senate bill 94 would conform to these changes.

- *Deduction for health insurance costs in computing self-employment taxes.* The 2010 Jobs Act allows self-employed individuals to deduct the cost of health insurance for the individual and immediate family to determine income subject to federal self-employment taxes. Health insurance costs were already deductible for regular income tax purposes. The reduction in

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self-employment taxes affects North Carolina taxable income because self-employment taxes were deductible in determining State taxable income. Self-employed taxpayers with health insurance costs will have larger State taxable incomes because less self-employment taxes were imposed and deducted at the federal level.

- *Allow participants in governmental 457 plans to treat elective deferrals as Roth contributions.* The 2010 Jobs Act gives participants the option to move retirement savings from government 457(b) plans to Roth accounts starting in 2011. The conversion will be taxable while the earnings and distributions from Roth accounts are generally tax free.
- *Allow rollovers from elective deferral plans to Roth designated accounts.* The 2010 Jobs Act allows retirement plans to offer participants the option starting September 27, 2010 to rollover distributions into Roth accounts within the same retirement plan. The rollover will be taxable while the earnings and distributions from the Roth account are generally tax free.
- *Permit partial annuitization of a nonqualified annuity contract.* The 2010 Jobs Act allows the owner of an annuity contract to begin receiving benefits based on a portion of the value of the annuity and leaving the balance of the annuity to accumulate earnings tax free. This option starts in 2011.
- *Source rules for income on guarantees.* The 2010 Jobs Act clarifies the federal tax treatment of guarantee fees as income sourced to the United States if connected to the United States by a domestic payer or by the conduct of a trade or business in the United States.

EFFECTIVE DATE: Senate Bill 94 would become effective when it becomes law. However, any amendments to the Internal Revenue Code enacted after May 1, 2010, that increase North Carolina taxable income for the 2010 taxable year or impose an estate tax on the estate of a decedent dying in calendar year 2010 would become effective for taxable years beginning on or after January 1, 2011.

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